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Foreign Economic Trends and Their Implications for the United States

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SRI LANKA

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SRI LANKA: KEY ECONOMIC INDICATORS

Population (mid-1989): 16,806,000
Area: 65,607 sq km
Per Capita GNP (1988): $367

	1988	1989	1990 Proj.
Domestic Economy (Rupees Millions)			
GDP at Current Factor Costs	203,516	228,373	265,000
Fixed Capital Formation	49,961	54,249	63,000
GDP at Constant 1982 Factor Costs	119,050	121,729	127,000
Real GDP Growth Rate (%)	2.7	2.3	4.0
Money, Prices and Government Finance			
M2 Growth Rate (%)	16	12	10
Retail Price Index (% Change)	14	12	18
Government Deficit (% of GDP)	21	15	15
Balance of Payments ($ millions)			
Exports	1,476	1,556	1,700
To United States	367	399	450
Imports	2,234	2,222	2,300
From United States	153	137	160
Trade Balance	-758	-666	-600
Current Account Balance	-384	-342	-320
Direct Investment	43	27	35
Foreign Aid (Grant and Loan)	551	464	550
From U.S.	47	58	50
External Debt (Year End)	5,125	5,744	6,000
Debt Service	541	471	550
Official Reserves (Year End)	288	323	350
Avg. Exchange Rate (RS. per $)	31.81	36.05	42.00

Main imports from the United States (1989): wheat ($64 million), aircraft and aircraft parts ($7 million).
Main exports to the United States (1989): textiles and garments ($323 million), tea ($25 million).

Sources: Central Bank, Customs, Embassy estimates & forecasts.

Summary*

Sri Lanka recorded a third straight year of disappointingly slow growth in 1989, but given the difficult conditions which the country faced last year, any economic gain must be considered an achievement. Adverse weather conditions depressed agricultural output, while all sectors of the economy experienced disruptions from politically motivated strikes and terrorist activity. Nevertheless, output in the industrial and service sectors increased by enough to offset the losses in agriculture. Both the trade balance and the current account improved, although one factor in that improvement, sharply reduced imports of capital equipment, would become a worrisome development if it continued in future years. Foreign exchange reserves increased thanks to balance-of-payments support from the IMF and ADB. Sri Lanka's performance under an IMF Structural Adjustment Facility (SAF) concluded in February 1988 remains satisfactory. The government's budget deficit shrank as a proportion of GDP and monetary growth slowed. However, inflation and continued terrorist activities remained a very serious concern during 1990.

Relations between Sri Lanka and the United States are cordial. In 1990 the United States ranked first among Sri Lanka's markets and second among its suppliers. Sri Lanka offers a modest but growing market for U.S. products. The government is actively seeking foreign investment and offers a wide range of incentives to new business ventures.

PART A - CURRENT ECONOMIC SITUATION AND TRENDS

Political Setting: Sri Lanka is a parliamentary democracy with a strong executive presidency. The current government was elected in 1989 on a platform which emphasized poverty alleviation. It also promised to continue the economic liberalization efforts of the previous government. Its record during its first 18 months in office has been generally positive toward the private sector. Government controls have been loosened in many areas of the economy, and progress has been made toward privatization of some state-owned enterprises. Some industries, however, such as pharmaceuticals, have seen increased restrictions on their activities. The government is actively seeking foreign investment.

Sri Lanka's ethnic conflict dominates the domestic political scene. 1989 was a particularly troubled year in which the government had to contend with threats from Tamil separatists in the northern and eastern parts of the island and a violent Sinhalese subversive movement in the rest of the country. A bloody counter-insurgency campaign conducted by the Sri Lankan security forces had suppressed the Sinhalese extremists by the end of the year.

*This report was updated in December 1990.

By the summer of 1990, however, very heavy fighting broke out between security forces and the Liberation Tigers of Tamil Eelam (LTTE) and is still going on in December of 1990.

Recent Economic Performance: Economic performance declined somewhat in 1989, with real GDP growth slowing to 2.3 percent. The following table presents growth statistics by sector during 1988-89. All figures are percentage changes in output over the preceding year:

	1988	1989
Agriculture, Forestry & Fishing	2.1	-1.1
Mining and Quarrying	9.0	5.4
Manufacturing	4.7	4.4
Construction	1.5	0.6
Services	2.2	3.2
GDP	2.7	2.3

Source: Central Bank

Production of rice, Sri Lanka's staple cereal, dropped 17 percent in 1989. Both average yields per hectare and the acreage sown decreased, as drought and terrorist activities during planting and harvesting combined to produce the lowest production level since 1979. Output of other agricultural staples also declined for similar reasons. The 1989-90 Maha paddy crop, however, which usually accounts for about two-thirds of Sri Lanka'a annual rice production, yielded a bumper harvest.

Output was also down in the plantation sector, which suffered from the same one-two punch of unfavorable weather conditions and civil unrest. Tea production dropped sharply in 1989, but higher world prices almost offset the decline in output. Less positive were the results in rubber and minor agricultural products. Only the coconut industry reversed the negative trend, with a strong production increase of 28 percent more than offsetting slight declines in prices. All sectors of the plantation industry have benefited from the improved weather and security conditions during the first half of 1990, significantly boosting their production levels over the same period last year.

Manufacturing output increased only 4.4 percent in 1988, dragged down by a 0.5 percent decline in agricultural processing. The output of private industry, the source of most of last year's economic growth, increased a remarkable 15 percent while the production of state-owned industries decreased 21 percent. Fabricated metal products, with 17 percent growth, and garments and textiles, with 16 percent growth, showed the largest gains. Output of paper and paper products, which declined 20 percent, and chemicals and petroleum products, which declined 18 percent,

recorded the biggest losses. Performance in the remaining sectors of the economy was mixed.

Balance of Payments: Exports increased and imports decreased in 1989, leading to improvements in both the trade and the current account deficits. The value of Sri Lanka's top foreign exchange earner, garment exports, increased 9 percent in dollar terms. Exports of coconuts were also up a whopping 58 percent. Exports of tea, rubber, and minor agricultural products all decreased, however, by 2 percent, 26 percent, and 17 percent, respectively. Imports of food and beverages surged 22 percent last year to fill the gap left by the fall in domestic agricultural production. This increase was offset, however, by a 13 percent decline in petroleum imports and a 22 percent decline in capital equipment imports.

The following table presents trade statistics by sector for 1989. All figures are in millions of dollars:

Exports		Imports	
Textiles & Apparel	488	Textiles & Apparel	276
Tea	379	Petroleum	232
Rubber	86	Machinery & Equip.	174
Coconut	79	Wheat & Flour	143
Minor Agri. Products	67	Sugar	120
Petroleum Products	62	Motor Cars & Cycles	80
Gems	61	Milk & Milk Products	64
Other	334	Other	1133
TOTAL EXPORTS	1556	TOTAL IMPORTS	2222

Source: Central Bank.

Average prices for all of Sri Lanka's major exports, with the exception of tea, declined in 1989. Meanwhile, prices for major imports continued to rise. As a result, Sri Lanka's terms of trade deteriorated by 6 percent in 1989. This was on top of a decline of 7 percent which occurred in 1988. The direction of trade remained unchanged. The United States maintained its position in 1990 as Sri Lanka's number one market and second as supplier.

Remittances from Sri Lankans abroad made an important contribution to the balance of payments again in 1989, but continued a five-year decline when measured in dollar terms, falling by 6 percent. Revenues from tourism and transportation services, thanks mainly to earnings from the port of Colombo, increased significantly. Tourism was up strongly in 1990 and looked set for a banner year.

Debt service payments were 24 percent of export and service receipts in 1989, down from 29 percent in 1988. Interest payments grew while amortization payments declined. Combined with a 12 percent jump in external debt outstanding, this situation suggests that the drop in the debt service ratio is only a temporary phenomenon.

With the overall balance in deficit for the fifth straight year, Sri Lanka's foreign exchange reserves remained under pressure. Nevertheless, gross official reserves rose 8 percent thanks to balance-of-payments support from the International Monetary Fund (IMF) and the Asian Development Bank (ADB). The level of reserves at the end of the year was sufficient to finance about 2 1/2 months of imports.

Investment: Gross domestic fixed capital formation increased 8.5 percent in nominal terms in 1989. The increase came entirely from the corporate sector as public sector investment shrank 13 percent. Foreign direct investment decreased significantly. Investors have been no doubt discouraged by the political unrest and violence.

Government: Budgetary performance improved dramatically in 1988 as the deficit before grants decreased to 15 percent of GDP. Government revenues increased and expenditures decreased as a percentage of GDP. Current expenditures increased 19 percent, while capital expenditures decreased 14 percent, another sign of the impact of last year's disturbances on investment. Total official debt rose to 272 billion rupees, equivalent to 119 percent of GDP, by the end of the year.

The following table presents government fiscal operations as a percentage of GDP. 1989 figures are provisional; 1990 figures are estimates:

	1988	1989	1990
Revenues	23	25	24
Expenditure	44	40	39
Defense	6	4	4
Debt service	11	11	12
Deficit	21	15	15
Domestic finance	12	7	7
Foreign loans and grants	9	8	8

Source: Central Bank; Government Budget Projections.

Money and Prices: Money supply growth slowed somewhat in 1989. Broad money (M2) grew at a 12 percent rate, down from 16 percent in 1988. The official retail price index rose 12 percent. The public perception, however, was that inflation was actually higher. The official inflation rate accelerated to 21 percent during the first quarter of 1990.

Employment: There are no reliable figures for unemployment in Sri Lanka. Semiofficial estimates place it at around 20 percent. Over 150,000 young Sri Lankans reach working age each year.

Prospects: Economic growth picked up in 1990. Favorable weather conditions had a positive impact on agricultural output.

Business has been good in the garment sector. Tourism rebounded strongly in 1990. The travel industry is expecting its best year since 1985. The security situation in the North remains a "wild card" factor with potentially negative consequences for economic growth and development.

Government efforts to recruit new foreign investment should start to bear fruit this year, and the third and final tranche of the IMF facility should provide additional balance-of-payments support. The debt service ratio is likely to move back toward the 30 percent level as normal repayment patterns resume.

Two significant, and possibly contradictory, policy challenges facing the government in the year ahead are unemployment and inflation. The government has identified unemployment, particularly youth unemployment, as a root cause of the social unrest which has caused so much trouble in recent years. Various programs are being developed to provide training and create jobs for the unemployed. Meanwhile, the cost of living is becoming an increasing burden for those who have jobs. Production disruptions, depreciation of the rupee, and the removal of government subsidies at the behest of the IMF (to curtail budget deficits) are all fueling inflation in the short run.

Part B - IMPLICATIONS FOR THE UNITED STATES

Trade: Sri Lanka is relatively open to foreign trade. The government swept away most foreign exchange and import controls in 1977 and streamlined the tariff schedule in 1984. Tariff protection for domestic industries still impedes full access the Sri Lankan market, but few U.S. goods are affected. More significant for U.S. exporters are the tighter credit controls on "nonessential" imports, which were imposed in June 1989. These controls appear to have restricted demand for many manufactured and consumer items. While they were introduced as a temporary measure, the government appears to be in no hurry to end them.

The United States is Sri Lanka's largest trading partner. Sri Lanka sent goods worth $399 million to the United States in 1989, about one-quarter of the country's exports. Garments accounted for almost 80 percent of the total. In turn, the United States shipped $137 million worth of goods to Sri Lanka. Wheat exports, valued at $64 million, led the list. Most U.S. wheat sales have been financed by PL-480 concessional loans or supported by other U.S. Government programs.

With a population of 16.8 million and a per capita GDP of less than $400, Sri Lanka represents a modest market for consumer items. Much of the rural population exists at a fairly basic level of development, but Colombo and other urban areas offer a more sophisticated group of consumers.

Private investment has declined in recent years owing to the unsettled conditions. Nevertheless, local firms and foreign joint ventures are beginning to look again at expanding their operations and should offer a gradually growing market for capital and intermediate goods. Few large infrastructure projects are being undertaken, but a reconstruction program is under way in the war-torn northeastern section of the island.

The U.S. Embassy in Colombo has identified the following products as having the best market potential:

-- Automated Data Processing and Business Equipment
-- Food Processing and Packing Equipment
-- Pharmaceuticals and Medical Equipment
-- Agricultural Equipment and Related Products
-- Telecommunications Equipment
-- Security Equipment

Investment: U.S. investment in Sri Lanka has been modest. Interest rose after the economic liberalization which began in 1977 and several U.S. firms opened plants in the country's free trade zones. New projects continue to be undertaken, especially in the free trade zones where security is less of a concern.

The Sri Lankan Government actively seeks foreign investment and offers a wide range of tax and other concessions. While the garment and tourist industries have so far received most of the attention, the government encourages investment in other fields, including electronics assembly and raw materials processing.

The Greater Colombo Economic Commission (GCEC) offers one-stop service for foreign investors in Sri Lanka. In addition to facilitating investor relations with government agencies, the GCEC also can help with labor recruitment, utility hook-ups, and other basic business needs. It also manages the country's two free trade zones.

* U.S. Government Printing Office : 1991 - 282-906/20019